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# THE SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1931.

## No. 337.

WESTERN DISTRIBUTING COMPANY,
APPELLANT,

*vs.*

THE PUBLIC SERVICE COMMISSION OF THE STATE OF KANSAS, ET AL.,
APPELLEES.

APPEAL FROM THE DISTRICT COURT OF THE UNITED STATES FOR THE DISTRICT OF KANSAS.

## BRIEF ON BEHALF OF APPELLEES.

CHARLES W. STEIGER,
Topeka, Kansas,
EARL H. HATCHER,
Topeka, Kansas,
Solicitors for Appellees.

KELLEY BRIEF PTG. CO. TOPEKA

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## BRIEF ON BEHALF OF APPELLEES.

### OPINIONS OF THE COURT BELOW.

The opinions of the Court below were not reported but appear in the record of this proceeding on pages 49, 50, 53 and 56, with the decree at page 42, and an opinion overruling the first motion to dismiss at page 8.

### STATEMENT OF THE CASE.

The appeal is from an order and decree (R. 42) of a duly constituted three-judge statutory Court for the District of Kansas, consisting of Orie L. Phillips, C. J., J. Foster Symes, D. J., and Richard J. Hopkins, D. J. The decree denied the application of the appellant for

a temporary injunction and dismissed the cause. The matter was submitted upon the issues joined by the amended bill of complaint (R. 12) and the answer thereto (R. 27).

The appellant, the Western Distributing Company, by its amended bill of complaint, pray that the Public Service Commission for the State of Kansas be enjoined from enforcing the rate now on file for the City of El Dorado, and from interfering with the plaintiff, putting into effect a new rate. The appellant also asks for a temporary injunction pending the final determination of the suit (R. 2).

The appellees, by their answer, challenged the right of appellant to seek relief in a court of equity on the grounds the action was premature, the appellant having failed to exhaust its remedies before the Public Service Commission. The appellees based their allegation of appellant's failure to exhaust its remedy before the Public Service Commission on its failure and refusal to produce for the Commission evidence of the cost of service, and rate of return earned by holding and affiliated companies in justification of the reasonableness of the contracts. Payment for these alleged services and gas furnished by holding and affiliated companies made up a large part of the expense of appellant's plant at El Dorado.

The hearing on the preliminary issue raised by appellee's answer was heard on June 25, 1931. The evidence consisted of a stipulation as to the evidence introduced before the Commission respecting the holding or

affiliating company charges and certain affidavits filed by appellants (R. 62-89).

The motion to dismiss the appellant's bill of complaint as set out in appellee's answer was argued, and the court sustained the motion (R. 42), made findings of fact (R. 43) and conclusions of law (R. 48).

## HISTORY OF PROCEEDINGS.

On pages 3 to 20 of its Brief, appellant sets out what it terms a brief outline of the situation which existed at the time of the hearing.

Pages 3 to 10 sets out the early history of the pipe line company and reviews certain litigation in which the company was involved. Although this may be of some historical interest, it has no bearing upon the present case. The matters there set out were not before the Commission and were not presented to the court from which this appeal is taken. At the time the 40¢ rate was established for the gas pipe line company, it was represented that the gas supply was limited, and that rate was allowed for the purpose of conserving gas and amortizing pipe lines over a short period. It very quickly developed that the supply of gas was practically unlimited and that the basis upon which the 40¢ rate was established was erroneous, and the Commission set aside the order on December 20, 1924. Findings VII (R. 44).

On pages 7 and 8 of its brief, appellant lays considerable stress on a case filed by the Wichita Gas Company in the District Court of United States for the District of Kansas and takes issue with the failure of the Com-

mission to consider this matter as a binding adjudication as to reasonableness of the pipe line rate. The remarks there set out without explanation might lead to the opinion that the Commission is not willing to follow the decision of the Court. The Commission feels that it has a duty to perform both to the utility and the public in general. Its only attempt has been to determine the reasonableness of the pipe line rate and protect the utility from unjust criticism, or if the rate is unreasonable to have the matter settled out of fairness to the public. We submit that in none of the cases mentioned by the appellant has there been a proper determination of the pipe line company's rate or the holding company service charges.

The extent of the investigation into the pipeline rate in the Wichita Gas case was referred to in the hearing before the Commission and set out on page 66 of the record, as follows:

> "In response to an inquiry by Mr. Montgomery, then a member of the Commission, it was stated that the only valuation introduced was a general estimate by Mr. Hamilton, chief Engineer of Henry L. Doherty & Company, which was a general estimate in round figures. No exhibit was introduced, but his testimony occupied a day or two. It was stated by counsel for the applicant that no valuation, to his knowledge, had been made of the pipe line system; that he had been informed that it would cost $50,000.00 to $100,000.00 to make it."

This clearly indicates that there was no proper determination of the reasonableness of the pipeline rate charged to the affiliated distributing company.

It is admitted that the decisions of the State Courts and of the Federal Courts were introduced in the hearing before the Commission and that the Commission stated it would take notice of them, but the record of these cases was not introduced. The appellant did move to reopen the hearing before the Commission and introduced a complete transcript of the record in the Federal Court in the case of the Wichita Gas Company vs. The Public Service Commission (R. 78). The Commission's attorney then asked for time to familiarize himself with the record before it was introduced. Counsel for the appellant then stated: "I withdraw the motion. I would rather get it started in the courts and find out what the law is now." (R. 80.) This statement clearly shows that it was not the intention of the appellant to produce evidence of the reasonableness of the contracts between the affiliated companies and their desire to have the question determined as to whether or not such a showing had to be made.

On page 10 of its brief, plaintiff says that it appeared before the Commission believing that it would not be required to again litigate the question of the rates of the pipe line company. It was notified upon the first day of the hearing that evidence upon these items was necessary and it had two weeks in which to meet the requirement. Considerable emphasis is placed upon some statement made by an attorney in a previous case that the Commission would take the 40¢ rate as a starting point for future rate cases. If such a statement was made, it was made by a party not now connected with

the Public Service Commission and under a Commission not now in the office. It is elementary law that one public officer cannot by a statement bind a successor in office. We would, however, feel under obligation to follow any such suggestion when made, if conditions were not changed, if the courts had not since that time presented a theory of law which is different from the theories held by both parties with reference to the then existing law, and if the record did not disclose that a proper showing was not made at that time.

In the hearing now in controversy, the Commission was simply attempting to follow the law as laid down by the recent decision by the United States Supreme Court and its previous decisions requiring a public utility to justify the reasonableness of contract made with holding or affiliated companies.

The shifting contentions of appellant are indicative of the doubtful manner in which the reasonableness of the contracts between the distributing company and the holding or affiliated company was presented to the Commission.

In the hearing before the Public Service Commission the plaintiff took the position that the case of Smith v. Illinois Bell Telephone Company, 282 U. S. 133, was not applicable, and refused to submit evidence on the holding company charges which made up the major portion of the expense of the distributing company. The attorney for the Western Distributing Company stated to the Commission:

"If the Commission please, I am familiar with the decision of the Supreme Court of the United States in the Illinois case. I do not think it has any application, and I do not intend to argue it." (R. 77.)

Assuming that the appellant would stand upon this theory, the Public Service Commission filed a motion to dismiss the bill of complaint filed in the Federal Court on the ground that appellant had failed to exhaust its remedy before the Public Service Commission. When this issue was raised, the plaintiff changed its theory, and amended its bill of complaint, at the court's suggestion, to come within the rule laid down in Smith v. Illinois Bell Tel. Co. case.

Counsel for appellant at that time stated to the court:

"We stand ready, your honors, and we expect to introduce here the full valuation of the pipe-line company. We expect to go into these things and we expect to comply with the rules laid down in the Bell Telephone case as far—and to allocate all these things as far as possible to the El Dorado distributing company. We stand ready to do that."

The court then instructed the parties to abstract the record of the proceedings before the Public Service Commission and to file briefs on the question as to whether or not the appellant had made a sufficient showing on the holding company charges to exhaust its relief before the Public Service Commission. Believing that the appellant would stand on this theory, the appellees abstracted the record and submitted their brief showing that such proof was not made. The appellant again entirely reversed its position. It is now again contend-

expense. This is in conformity with the rule announced in Houston v. Illinois Bell Telephone Company, 259 U. S. 318; S. W. Bell Telephone Co. v. The Public Service Commission, 262 U. S. 276; and United Fuel Gas Company v. R. R. Commission, 278 U. S. 300.

The decision of the lower court, from which this appeal is taken, was limited to that extent. In its opinion the lower court said:

> "It is my opinion that the Commission in making inquiry into the city gate rate, should not approach that question as it would were it empowered to fix such rate, the inquiry should be for the purpose of determining whether the contract between the plaintiff and the Cities Service Gas Company, an affiliated corporation, is fair and reasonable, and such as prudent business men acting in good faith and in the exercise of a sound discretion would have entered into under similar circumstances." (R. 52)

This statement is in conformity with the previous decisions of the U. S. Supreme Court and justified the dismissal of the Bill of Complaint on that ground. It is our judgment, however, that in view of the decision in the case of Smith vs. Illinois Bell Telephone Company, 282 U. S. 133, the statement does not go far enough. In addition to using the cost of rendering the service and the rate of return earned as one of the elements in measuring the reasonableness of the contract, the cost of rendering the services and the rate of return earned should be the full measure of the reasonableness of the contract, and should determine what amount should be allocated in this respect to the operating expense of the distribution company.

It is also the contention of the appellees that the same measure should be used in determining the reasonableness of the contract between the Gas Service Company, a holding company of the Western Distributing Company, and the distributing company for services rendered, and the same measure should determine the reasonableness of the contract by which the distributing company pays to Henry L. Doherty & Company one and three-fourths per cent of its gross earnings.

## ARGUMENT.

The matter is now before the Court on two major issues—

**1. The issue of fact.**

Is the evidence sufficient to make a prima facie showing of the reasonableness of the contracts under which service is rendered and gas furnished by the holding and affiliated companies?

**2. The issue of law.**

Must a public utility introduce evidence before the Public Service Commission upon which it can make findings as to the reasonableness of contracts under which services are rendered and gas furnished by holding and affiliated companies?

## THE ISSUE OF FACT.

The undisputed facts in so far as they are material to the issue are as follows:

> "On July 29, 1929, the Western Distributing Company filed its applications with the Public Service Commission of the State of Kansas for increase in rates charged for natural gas in twenty-two cities and towns including El Dorado, Kansas. The applications were set for hearing but continued from time to time on the request of the applicant to enable the engineers to prepare inventories and appraisals. On January 7, 1931, the applications were again set for hearing and counsel for the applicant stated it was prepared only on the El Dorado case at that time. Hearings on the El Dorado application were heard on January 7, 8 and 21. The undisputed evidence of the applicant disclosed:
>
> "1. The applicant, the Western Distributing Company, is a corporation engaged in the business of a public utility furnishing natural gas to consumers in the city of El Dorado, Kansas.
>
> "2. Its capital stock is owned by the Gas Service Company, a corporation, a holding company owning, through stock ownership, and operating many public utilities, in Kansas, Missouri and Oklahoma.
>
> "3. The capital stock of the Gas Service Company is owned by the Cities Service Company, a corporation holding the capital stock of several hundred public utilities throughout the United States.
>
> "4. The capital stock of the Cities Service Gas Company is owned by the Empire Gas and Fuel Company, a corporation.
>
> "5. The capital stock of the Empire Gas and Fuel Company is owned by the Cities Service Company.
>
> "6. The Cities Service Company is the common

owner of the companies recited above and the companies are mere agencies and instrumentalities of it.

"7. Henry L. Doherty, doing business as Henry L. Doherty & Company, through agency contracts, manages and controls the operations of all these companies, both in their relations with the public and between themselves.

"The evidence also disclosed:

"1. The Western Distributing Company pays 1¾ per cent of its gross revenue to Henry L. Doherty & Company. This payment in the amount of $3,454.43 was included in the items of expense for the El Dorado plant.

"2. The Gas Service Company operates and manages the Western Distributing Company and keeps the books of the Western Distributing Company in Kansas City, Missouri, and charges to the Western Distributing Company certain sums annually, purporting to be the Western Distributing Company's share of expense of the Gas Service Company. These charges, amounting to $5,970.11, were included in the items of expense for the El Dorado plant; also unclassified expense amounting to $4,667.91.

"3. The Western Distributing Company buys its supply of natural gas from the Cities Service Gas Company. There was included in the items of expense for the El Dorado plant the sum of $176,260.32 paid to the Cities Service Gas Company for gas purchased." (R. 62, 63)

It is admitted by the appellees that the appellant produced sufficient evidence to make a *prima facie* showing upon all issues except the cost of services rendered and gas furnished and rate of return earned by the holding or affiliated companies. After the Western Distributing Company rested its case the attorney for the Public

Service Commission moved that the application be denied, alleging in substance that:

1. Under the decision in the case of *Smith v. Illinois Bell Telephone Company*, 75 L. Ed. 99, it was necessary for the Commission to make findings as to the cost of services rendered and rate of return earned by the holding or affiliated companies, and that it was incumbent upon the applicant to produce evidence upon which such findings could be made.

2. The applicant failed and refused to produce for the Commission evidence showing the cost to the above-mentioned affiliated companies in rendering services and furnishing gas; and produced no evidence as to the value of the services. On request of the Commission the witnesses for the applicant refused to produce evidence on any of these items, although one of the witnesses admitted such information was in his possession. His refusal to make such disclosures was done on advice of counsel.

3. The Western Distributing Company, through its owner, the Cities Service Company, and by reason of its management and control by Henry L. Doherty & Company, had in its possession and could have produced, or caused to be produced, before the Public Service Commission, testimony showing the reasonable and fair cost of gas delivered by the affiliated company to the applicant.

4. The Western Distributing Company, through its officers and employees, who are also officers and employees of the Gas Service Company, have in their possession and control books and records and other evidence show-

ing the kind and amount of the expenditures of the Gas Service Company, but they failed to produce such evidence and refused to produce it or make such data available to the Public Service Commission.

5. The Western Distributing Company failed and refused to produce any evidence of the services rendered by Henry L. Doherty and Company in consideration of the 1¾ per cent payment, or of the cost of rendering the service. (R. 74-77)

The attorney for the applicant argued that the Illinois Bell case, *supra*, was not applicable. (R. 77)

The Commission, after taking a ten-minute recess, denied the application on the motion of its attorney.

The attorney for the applicant then asked permission to reopen the case and introduce the record of the Wichita gas case tried in the Federal Court. (R. 78)

The Commission then granted the request, but was continuing the case to give its attorney time to examine the record, when the attorney for the applicant said: "I will withdraw the motion. I would rather get it started in the courts and find out what the law is now." (R. 80)

**Was the evidence sufficient to enable the Public Service Commission to make a finding as to the reasonableness of the contracts under which services were rendered and gas furnished by holding and affiliated companies?**

A condensed statement has been prepared which sets out the evidence before the Public Service Commission on these issues.

Some evidence will be found elicited, however, on cross

examination, that the services were worth to the distributing company what it paid for them, and that gas could not be procured for less. This evidence throws no light upon the issue. The Commission must determine what it costs the parent company to render the service and whether or not it is earning more than a reasonable return.

There are three such expense items at issue in the present appeal:

1. The 1¾ per cent gross revenue charge, paid to Henry L. Doherty & Company. This payment amounted to $3,454.43.
2. The Gas Service Company's managerial charge amounting to $10,638.02.
3. The purchase of natural gas from the Cities Service Gas Company amounted to $176,260.32.

The amount paid to the holding or affiliated companies totaled $190,352.77. This was the major part of the expense of the Distributing Company.

They shall be discussed in order in which they appear, as to the sufficiency of the showing of cost of service and rate of return to the holding or affiliated company, and the reasonableness of the contracts.

## I.

### The Doherty 1¾% Charge.

The appellant offered in evidence before the Commission the decisions of the Federal Court and of the Kansas court in support of this charge. The Commission stated that it would take notice of the decisions. (R. 64)

It is understood, of course, that the Commission must take notice of the decisions of the courts as to the law involved, but these decisions throw no light upon the cost to Henry L. Doherty & Company to render the service for which he was paid 1¾ per cent of the gross revenue, nor of the rate of return earned by him.

Mr. Rice, called as a witness for the applicant, testified that this 1¾ per cent charge was fixed by Henry L. Doherty; he also testified that the service which Henry L. Doherty was to perform was in a proposal accepted by the Distributing Company's board of directors. (R. 65)

When questioned about the 1¾ per cent Mr. Rice testified:

> "I know generally about it, but nothing specific.
>
> "Q. What services have been furnished by Henry L. Doherty & Company under this contract? A. I could not tell you just offhand.
>
> "Q. Well, would your office have any accounts at all of any value received under this proposal from Henry L. Doherty & Company? A. As to specific entries, I would not have them.
>
> "Q. Will you state as a matter of fact that they do not have any record? A. No. I don't know that." (Summarized R. 65)

As this witness, who was the accounting engineer, knew nothing specific about the services performed—did not even know whether there was a record of any services performed—it would be useless to peruse his testimony further.

Mr. Adams, vice president and manager of the Gas Service Company, and president of the Western Distributing Company, was the only other witness to testify. He did testify that in his judgment the services were worth to the Distributing Company the price that was paid for them. (R. 69)

This testimony, however, is not evidence of the actual test in the case—that is, what it cost Henry L. Doherty to furnish the service and what his earnings were. No other testimony can be found in the record pertaining to the cost of rendering the service by Henry L. Doherty & Company. Mr. Adams did, on the advice of counsel, refuse to submit such evidence. (R. 71)

Mr. Adams refused to give access to the books so that the Commission could determine the actual expenditure made by the company in performing these services. "A. As I say I am guided by advice of counsel on that."

The advice of counsel was that the courts had held it was not necessary for the Commission to have the books: "The attorneys will tell you now—no." (R. 71)

This certainly is not evidence upon which the Commission could make a finding as required by law as to the 1¾ per cent charge. The testimony as set out also exposes the contention of the plaintiff that it was surprised when the Commission entertained a motion to deny the application for lack of evidence to enable it to make a finding on this item.

## II.

### The Gas Service Company Managerial Charge.

Mr. Rice was first questioned as to this charge:

> "Q. Can you state what the services were? A. Yes. We furnished all administrative and executive service, financial aid and advice, general purchasing and warehousing operations are handled by the Gas Service Company.
>
> "Q. You are reading from the contract what they will do if requested? A. I am reading from what they actually do handle, all general engineering, and operating supervision, all legal services, all insurance purchases; all general accounting is done by the Gas Service Company, they have supervision and handling of all tax matters, handle all pay rolls, they make all audits and audit reports." (R. 66)

The above information was given by Mr. Rice on cross examination. He gave no further testimony on the managerial charge. This testimony was given from a memoranda of what the Gas Service Company contracted to perform. There is no testimony as to what services were actually performed nor the cost thereof.

No exhibit was prepared showing the total expense of the Gas Service Company.

Mr. Adams gave no testimony as to the cost of rendering these services or the value thereof. He did testify that he had access to the books of the Gas Service Company which contained the information requested by the Commission. He was then asked:

> "Q. Will you produce that information? A. I will be guided by the advice of attorneys." (R. 71)

ing that the Smith case is not applicable, and that a showing as to these items is not necessary. In its brief in the lower court, appellant stated:

> "No clearer cut issue than this could exist, as the motion was on one ground. The ruling was on one ground. The correctness of that ruling is the one issue before this court. If the Smith case does apply and if as stated by the Commission's attorney (Abs. 23) 'The Supreme Court in speaking through its chief justice, has apparently, using the common every-day language, made a new law,' then the motion was properly sustained."

It is not the theory of the appellees that any new law was necessary to support the ruling of the Commission and that of the Federal District Court. Decisions previous to that of the Smith vs. Bell Telephone Company, 282 U. S. 133, had laid down the rule that the Commission might inquire into reasonableness of charges made by holding or affiliated companies for the purpose of fixing the local rates of an operating unit. (Houston vs. Southwestern Bell Tel. Co., 259 U. S. 318; Southwestern Bell Tel. Co. vs. Public Service Commission, 262 U. S. 276; United Field Gas Co. vs. Railroad Commission, 278 U. S. 300.)

This matter is now of great importance to the State of Kansas in view of the fact that the pipe line company supplies gas to approximately 100 distributing plants in Kansas which serve the important cities of the state, and the regulations of rates of these distributing plants is impossible, if the pipe line company is in position to exact any charge that it sees fit without regu-

lation, in view of the fact that all of the companies are responsible to their holding company, the Cities Service Company and the earnings of both companies are received by it.

## SUMMARY OF ARGUMENT.

1. It is the contention of appellees that a utility must exhaust its remedy before the Commission before seeking injunctive relief.

2. That a utility has not exhausted its remedy before the Commission until it has produced evidence upon which findings can be made upon all material issues affecting the rate, including the cost of services rendered and gas furnished by a holding or affiliated company and set up as expense items.

3. That the cost of services rendered and for gas furnished by holding and affiliated companies is a material issue to be determined by the Commission in measuring the reasonableness of the contracts.

It is not our contention that the Public Service Commission has authority to fix a rate for which gas shall be sold by an interstate pipe line company. It is our contention, however, that where the pipe line company is affiliated with the distributing company by reason of the capital stock of the pipe line company and the distributing company being owned by a common holding company, that the Commission can inquire into the reasonableness of the charge made by the pipe line company for the purpose of determining whether or not the charge is unreasonable and reflects an unreasonably high operating

The attorneys advice was "no." (R. 71)

The record contains no evidence of what services were rendered, if any, and what the cost of the services was.

## III.

### The Cities Service Gas Company's Gas Purchase Charge.

Considerable effort was made by the Commission to obtain information as to the cost to the Cities Service Gas Company in furnishing gas and the rate of return earned, because of the size of this expense item and the effect it had upon the rate. The record, therefore, has considerable testimony referring to this item, but it will be found absolutely void of any testimony as to the cost of furnishing the gas and the rate of return earned.

The former decisions of the Kansas Supreme Court and of the Federal Court were introduced. The record in these decisions was not introduced, however. The Commission is ready to admit that it must take notice of the decision; however, there is no evidence in those decisions on the issue now before the court. Those decisions are not *res adjudicata*. The present record contains testimony as to the limited extent to which the matter was gone into in the cases cited. (R. 66) In view of the fact that the decisions are not *res adjudicata* the absence of sufficient evidence to enable the courts to make an intelligent finding upon these issues need not be discussed.

Evidence was introduced to the effect that the gas could not be purchased cheaper and that there was no other source of supply. This testimony, however, throws

no light upon the question as to what it costs to furnish this supply and the rate of return earned. Because of the peculiar conditions surrounding gas service it would, of course, be impossible to get any company to parallel the present pipe line into the city of El Dorado. It is even possible that the pipe-line company could charge a much higher rate than it is now charging and still not be troubled with competitive pipe lines. Such a charge, however, would be unreasonable and the rate of return could not be justified.

Mr. Rice testified that he had no information in regard to pipe line matters other than what he heard in the Wichita rate case and had made no study of what it cost the pipe line company to deliver gas. (R. 66)

Commissioner Montgomery then read from the recent decision in the Illinois Bell case showing the necessity of findings upon this point and asked if the accountants for the applicant had given the matter consideration and if he had prepared exhibits along that line. The witness replied that he had not. This happened upon the first day of the hearing and the case was later adjourned for two weeks. Certainly the appellant cannot contend that it did not have warning that the Commission would require such evidence and did not have an opportunity to prepare it. The Commission not only requested such information, but read from the decision which made the evidence mandatory. (R. 67)

Mr. Adams testified that his only knowledge came from testimony submitted in the Wichita case and what he had been told about the earnings of the company and its in-

vestments. He did not seem, however, to be quite clear on the matter, as he testified: "It seems to me there was some testimony of that character, covering cost of delivering gas exclusive of all overheads." He also testified that he and his board of directors had made no investigation as to the reasonableness of the 40-cent charge other than what he had heard. "My theory about the price that the Distributing Company pays for gas is this. We are less interested in the price we pay for gas than we are in the ability of the company to deliver us gas at all times during the peak load and during the loads that are less than those loads during peak hours." (R. 70)

This factor may not be of very much importance to the Distributing Company, but it certainly is an important factor to be considered by the Commission in determining the reasonableness of the rate, in view of the fact that the earnings of both the Distributing Company and the pipe-line company are received by the same company.

The attitude of the appellant as to the insufficiency of the evidence to show the cost of supplying gas and the rate of return earned by the pipe-line company is indicated by its attitude following the denial of the application.

The attorney for the Public Service Commission moved to have the Commission deny the application. He quoted from the Illinois Bell Telephone case, and cited the necessity of the Commission making findings upon the issues now in controversy. (R. 75)

The attorney for the appellant then stated:

> "If the Commission please, I am familiar with the decision of the Supreme Court of the United States in the Illinois Bell case. I do not think that it has any application and I do not intend to argue it. It is immaterial whether it is applicable or whether it is not. *** Well, I don't think the rule is applicable because your telephone companies are engaged in interstate business. They have their interstate calls as well as their local calls." (R. 77)

After the Commission denied the application because of the insufficiency of the evidence on the three items of expense to enable them to make a finding as to what constituted a reasonable rate, the attorney for the applicant then moved that the case be reopened and that it be permitted to introduce the complete transcript of the record in the Wichita gas case. (R. 78) The attorneys for the Public Service Commission then asked for an opportunity to examine the proceedings in the Wichita gas case. (R. 79) The Commission granted the motion to reopen, and was continuing the case to give its attorneys who were unfamiliar with the transcript an opportunity to examine the proceedings, when the attorney for the applicant stated:

> "I will withdraw the motion. I would rather get it started in the courts and find out what the law is now." (R. 80)

It therefore clearly appears that the only evidence which would have enabled the Commission to in any way make a finding upon the issue was withdrawn by the applicant to enable it to get the case into court to deter-

mine whether or not it had to submit evidence upon these issues.

**Allegations in Paragraph XIII of Answer.**

In view of the fact that appellant has attempted in paragraph XIII of its amended answer to allege facts which would bring it within the jurisdiction of a court of equity, and those allegations deal with the issue of fact just discussed, it may be well to take up briefly those allegations as they appear in the appellant's bill of complaint.

The amended bill of complaint is set out in the transcript of record and the beginning of paragraph XIII appears on page 18.

In paragraph XIII of this amended bill of complaint appellant states:

1. **"That plaintiff thereupon introduced evidence substantially as follows:" and the following statements appear:**

(*a*) There was no other source of supply.

(*b*) No gas had ever been offered at a cheaper rate.

(*c*) Plaintiff would purchase cheaper gas if offered by any other company.

(*d*) Cost of bringing gas to the city gate had not altered greatly for quite a few years.

(*e*) That it cost just as much now as fifteen or sixteen years ago.

(*f*) There has been no change in the city gate rate since 1923.

(*g*) In the opinion of an expert witness, 40¢ gate rate was reasonable.

(*k*) All cities on the Cities Service Gas Company system receive their supply from a common source.

(*i*) The price is the same as to all cities not having local gas.

(*j*) An effort was made to find local gas available to El Dorado, but none was found.

(*k*) The president of the Western Distributing Company had heard it was not earning a fair return.

(*l*) The 40¢ gate rate was established to encourage gas operators to go farther for an adequate supply.

(*m*) When 40¢ gate rate was established all the larger cities were not owned or associated with the Cities Service Gas Company, and that no change has been made in the city gate rate since those cities were acquired.

(*n*) The city gate rate was established by the Kansas Commission in 1923.

(*o*) There has been no change in conditions that might make the rate unreasonably low.

(*p*) The Western Distributing Company had tried to get a lower rate from the Cities Service Gas Company, but could not.

(*q*) The properties at Lawrence and other towns are owned by outside interests and pay 40¢ at the gate.

Evidence, if any of a substantial character can be found, in support of the statements set out, is immaterial and has no bearing on the question as to the cost to the pipe-line company in furnishing gas at the city gate of El Dorado and the rate of return earned. This evidence, perhaps, might have been competent under the theory that the Commission could not take into consid-

eration the cost which the Distributing Company paid for the gas at the city gate, but it is not competent and in no way tends to show what it cost the pipe-line company to render the service, and we do not believe that sufficient evidence can be found in the record to even justify the irrelevant statements set out above.

The statement, under (*k*), that the president of the Western Distributing Company had heard the pipe-line company was not earning a fair return, is hearsay and not competent evidence and furnishes no basis upon which the Commission can make a definite finding as to a reasonable rate.

**2. The allegation that the Commission asked for no evidence in addition to that introduced by the appellant is without foundation and not supported by the record.**

This allegation is clearly not supported by the record. While Mr. Rice was on the stand Commissioner Montgomery questioned him as to the cost of gas at the city gate. He read from the Illinois Bell Telephone case, which required that there be findings upon this issue, and then said: "That is, as I understand it, the Supreme Court remanded this case for findings as to what it cost the Western Electric Company to produce the material which it sold to the Bell Company. I wondered if you had given that consideration." Then he quoted further from that opinion and asked: "You have not prepared any statement along that line?" (R. 68)

Commissioner Montgomery also asked for additional evidence as to the 1¾ per cent charge and as to the

managerial charge, and when the witness testified that they did not have any such information prepared, he asked if the books of the company would be available for the Commission, so that the Commission could ascertain such evidence for itself. The books being outside the state they could not be subpoenaed by the Commission. The attorney for the applicant then stated:

> "They are not and the courts have held it was not necessary for the Commission to have them." (R. 71)

Again with Mr. Adams on the stand he was asked:

> "Q. As an officer of the Western Distributing Company you do know what—or have information as to what services you pay for, or whether or not these services are reasonable, do you? A. Yes, sir.
>
> "Q. Will you produce that information? A. I will be guided by advice of attorneys." (R. 71)

This clearly indicates that paragraph XIII of the amended bill is without support in the record before the Commission.

**3. Appellant's allegation that it offered in evidence decisions of the Supreme Court of Kansas and of the Federal Courts.**

It is true that these decisions were offered in evidence, but the record of the decisions was not offered. The decisions are not *res adjudicata* and the law pronounced in a number of them is not altogether in conformity with the recent decision of the United States Supreme Court. The withdrawal of the record of the Wichita gas case

from the hearing before the Public Service Commission withdrew the part of the proceedings in the cases referred to which the appellant now contends would have enabled the Commission to make the necessary findings.

**4. Appellant's allegation that the holding company charges could have been disallowed by the Commission without affecting the findings.**

The plaintiff seems to overlook the proposition that the Commission must establish a definite rate. It could not make specific findings as to part of expenses and guess at the remainder and base the rate upon such a guess. If, however, the plaintiff is willing to forfeit its holding company charges there can be no argument about the sufficiency of the present rate. Payment to Henry L. Doherty & Company amounted to $3,454.43, and payment to the Gas Service Company amounted to $10,638.02; excess leakage, which the plaintiff admitted should be deducted in part, amounted to $23,000; merchandising expense and new business expense, which the courts have held is not a proper item to be considered in a rate case, amounted to $12,560. All of this item should not be deducted, but the evidence did not show the proper amount. This made a total expense of $46,198.02, not taking into consideration the $176,260.32 paid the holding or affiliated company for gas purchased.

**5. Appellant alleged in paragraph XIII that it was surprised by the motion to dismiss, there being no request for findings as to the managerial charges and that plaintiff was led to believe that no such request would be made.**

We have discussed under the second allegation set out above the repeated requests of the members of the Commission and their attorneys for additional information as to these managerial charges. It would serve no useful purpose to repeat that evidence here. It suffices to say that the Commission did ask for such information and it was refused on the advice of counsel; that the Commission had quoted from the Illinois Bell Telephone decision showing to the appellant that such evidence was necessary and that such findings must be made, in an effort to get the appellant to produce such testimony.

**6. Appellant's allegation that the transcription of its testimony in each rate case would be an impossibility because a number of the small towns would not justify the expenses.**

That contention is without merit. Henry L. Doherty & Company and the affiliated gas companies involved in this litigation have available books containing the desired information. The Commission did ask the Distributing Company to produce such information and when it refused asked for access to its books so that it could obtain the information for it. This was also refused. This information once obtained and properly made in exhibit form could be used in each of the cities under the control of the Distributing Company, and so far as time and

financial output is concerned their introduction in the separate cases would not consume fifteen minutes.

It might as well be admitted here that a certain amount of controversy has existed between these affiliated gas companies and the Public Service Commission for a number of years. The gas companies have been before the Commission for an increase in rates, they have cited the decisions of the courts and have refused to produce the desired information. Then they have gone into the courts and stood on the ground that the Commission was without authority to go into the books and into the pipe-line valuation. This has left a condition which is neither satisfactory to the Commission nor to the public generally and has placed the pipe line company in a position of suspicion. If their charges are reasonable and their records are clear there should be no objection to a disclosure. If they are otherwise public policy demands that a full disclosure be made. The Commission will be satisfied once a complete investigation of the pipe-line company is made and the books of the company have been audited, and it will be willing to take the gate rate found after such investigation and use it as a starting point for future rate cases. The Commission cannot be satisfied with anything short of such a complete disclosure.

The legislature of the State of Kansas has set up a Public Service Commission and given it the proper machinery with which to regulate public utilities and investigate rates. It is before this administrative body, as established by the legislature of the State of Kansas, that

the utilities should be required to seek their relief before going into the courts.

When a utility appears before the Public Service Commission the Commission and the utility should not be in the position of two litigants. The utility should not be allowed to make a brief showing and place the burden upon the Public Service Commission to find what the rate should be. In a majority of cases the evidence is strictly within the knowledge of the utility and can be disclosed only by the records of the company.

We believe that the foregoing statement as supported by the record clearly establishes the fact that the appellant labored under the impression that it was not necessary to make a showing as to the cost of rendering services by a holding company, and is now laboring to cover up that error.

## THE ISSUE OF LAW.

It is the contention of the appellees, under the facts heretofore set out, that the amended bill of complaint was properly dismissed under the issues raised by the appellees' answer. The bill was premature in that the appellant had not exhausted its relief before the Commission. The relief is legislative and must be exhausted before a public utility can ask relief from the courts. Relief before the Commission has not been exhausted where the utility has failed to produce evidence upon which the Commission can make a finding upon all material issues.

fore rates are fixed." (*Vincennes Water Supply Co. v. Public Service Commission*, 34 F. [2d] 5.) (Cer. denied. 280 U. S. 562, 72 L. Ed. 427.)

"Questions whether tariffs imposed by carriers are discriminatory must be raised in first instance before Interstate Commerce Commission or state public utilities commission." (*Oregon Short Line R. Co. v. Teton Coal Co.*, 35 F. [2d] 919, Syl. 9.)

"A temporary injunction will not be issued to prevent a state commission from compelling an interstate railroad to submit to its jurisdiction with respect to the location of its division point within the state, where there is nothing to show that the railroad company would be prejudiced by participating in the hearing before the commission, and awaiting the result thereof." (*Lawrence v. St. Louis-San Francisco Railway Co.*, 274 U. S. 588, 71 L. Ed. 1219.)

"Commission was fully justified in refusing to sanction a discontinuance of service until a petition had been filed with the commission and a showing made." (*Western and Atlantic R. v. Georgia Public Service Commission*, 267 U. S. 492, 69 L. Ed. 753.)

"The question of constitutionality of a state statute prohibiting a railroad from abandoning any portion of its service to the public without first obtaining permission from the state public service commission may not be raised by a railroad company which has discontinued interstate trains rendering intrastate service without first applying to the state public service commission for permission to do so, where no emergency existed requiring immediate action." (*St. Louis-San Francisco Ry. Co. v. Alabama Public Service Commission*, 279 U. S. 843, 73 L. Ed. 560.)

The same rule has been applied in attempts to resort to courts before presenting the issues to the Interstate Commerce Commission.

In *Simpson v. Shepard*, 230 U. S. 352, 419, 57 L. ed. 1511, 1550, the Supreme Court, speaking through Chief Justice Hughes, said:

> "The dominating purpose of the statute was to secure conformity to the prescribed standards through examination and appreciation of the complex facts of transportation by the body created for that purpose, and as this court has repeatedly held, it would be destructive of the system of regulation defined by the statute if the court without preliminary action of the commission were to undertake to pass upon the administrative questions which the statute has primarily confided to it."

In *Great Northern R. Co. v. Merchants Elevator Company*, 259 U. S. 285, 291, 66 L. Ed. 943, 946 it was said:

> "Whenever a rate, rule or practice is attacked, as unreasonable or as unjustly discriminatory there must be preliminary resort to the Commission. Sometimes this is required because the function being exercised is in its nature administrative, in contradistinction to judicial. But, ordinarily, the determining factor is not the character of the function, but the character of the controverted question and the nature of the inquiry necessary for its solution. To determine what rate, rule, or practice shall be deemed reasonable for the future is a legislative or administrative function. To determine whether a shipper has in the past been wronged by the exaction of an unreasonable or discriminatory rate is a judicial function. Preliminary resort to the Commission is required alike in the two classes of cases. It is required because the inquiry is essentially one of fact and of discretion in technical matters, and uniformity can be secured only if its determination is left to the Commission."

The appellant lays considerable stress upon the fact that an injunction proceeding against the Public Service Company is a trial *de novo*. On page 41 of its brief, the appellant states:

> "We supposed the law to have been well settled at the time this proceeding was heard by the court below that injunction proceedings brought to test orders of the Commission were trials *de novo* in which the proceedings before the Commission were entirely immaterial except as they might reflect upon the good faith of the party asking courts for relief."

On page 8 of its brief, the appellant also states:

> "Little is said in the Kansas statute in regard to the nature of the proceedings before the Commission and the same has been established more by custom and the decisions of the courts than by statutory provision. The proceedings are most informal and the Commission is authorized to procure its information in any reasonable manner, it being left to the courts to correct any injustice which might result to either party."

The appellant does and has appeared to labor under the impression that their showing before the Commission was entirely immaterial, and they were interested only in getting past the technical fact finding body of the Commission and into the courts. This, we do not believe to be the intention of the Public Service Commission statute, nor do we believe it to be the law as pronounced by the courts. Preliminary resort to the Commission is required because as stated, in Great Northern R. R. Co. v. The Merchant's Elevator Co., supra: "The inquiry is essentially one of fact and one of discretion

in technical matters, and uniformity can be secured only if its determination is left to the Commission." The legislative regulation of utility rates would be absolutely destroyed if utilities were permitted to submit but a small part of their evidence to the Commission—that is, to make what they call a "good faith showing"—and then go into the courts, submit all their evidence and ask for injunctive relief. This same situation was before the Supreme Court of the United States in Cincinnati, N. O. & T. R. R. Co. vs. The Interstate Commerce Commission, 162 U. S. 184; 40 L. Ed. 935, and the court held:

> "It is not proper for railroad companies to withhold a large part of their evidence from the Interstate Commerce Commission and first adduce it in the Circuit Court in proceedings by the Commission to enforce its order; but the purposes of the act of congress to regulate commerce called for a full inquiry by the Commission in the first instance." (Syl. 4.)

We also submit that the purpose of the public utility laws to regulate public utilities calls for a full inquiry by the Commission in the first instance. The utility having made a full disclosure before the Commission is then justified in seeking a trial *de novo* by injunction in the courts if it feels that it has a [redacted] grievance.

The dismissal of the bill of complaint now complained of by the appellants is simply a correction of their mistaken idea set out above—that the proceedings before the Commission were entirely immaterial as to the sufficiency of showing made by the utility to the Commission.

2.

**A utility has not exhausted its remedy before the Commission until it has produced evidence upon which findings can be made upon all material issues affecting the rates.**

Having determined that a utility must exhaust its remedy before the Commission before seeking injunctive relief, it now remains to be determined whether relief before the Commission is exhausted where the applicant seeking an increase in rates fails and refuses to introduce evidence upon such material issue upon which the Commission can make a finding.

To hold that a utility could make application for an increased rate and refuse to produce evidence justifying such increase would destroy any attempt to regulate rates by a commission. This would especially be true where the evidence is in possession of the applicant and they refused to produce it.

Should a utility be permitted to come before a commission, ask for an increase and state that they are operating at a loss, and rest their case? Such conduct could never be permitted before a fact-finding tribunal. The danger of such practice was very well expressed in the case of *Chicago & G. T. Ry. Co. v. Wellman*, 143 U. S. 338, 36 L. Ed. 176.

In determining the validity of a rate order, where confiscation was alleged under the federal constitution, the court said:

> "It is agreed that the defendant's operating expenses from 1888 were $2,404,516.54. Of what do these operating expenses consist? Are they made up

partially of extravagant salaries; fifty to one hundred thousand dollars to the president, and in like proportions to subordinate officers? Surely, before the courts are called upon to adjudge an act of the legislature fixing the maximum passenger rates for railroad companies to be unconstitutional, on the ground that its enforcement would prevent the stockholders from receiving any dividends on their investments, or the bondholders any interest on their loans, they should be fully advised as to what is done with the receipts and earnings of the company; for if so advised, it might clearly appear that a prudent and honest management would, within the rates prescribed, secure to the bondholders their interest, and to the stockholders reasonable dividends. While the protection of vested rights of property is a supreme duty of the courts, it has not come to this, that the legislative power rests subservient to the discretion of any railroad corporation which may, by exhorbitant and unreasonable salaries, or in some other improper way, transfer its earnings into what it is pleased to call 'operating expenses.'

"We do not mean to insinuate aught against the actual management of the affairs of this company. The silence of the record gives us no information, and we have no knowledge outside thereof, and no suspicion of wrong. Our suggestion is only to indicate how easily courts may be misled into doing grievous wrong to the public, and how careful they should be not to declare legislative acts unconstitutional upon agreed and general statements, and without the fullest disclosure of all material facts."

The Commission had denied the application, out of which this application for a restraining order grew, for failure to make a full disclosure of all material facts.

"The burden of proof that the proposed increase, charge or alteration in rates is just and reasonable

is placed upon the utility making the application." (*New Jersey C. T. Co. v. Board of P. U. B. Utility Commissioners*, N. J. L., 113 A. T. L. 692.)

The Supreme Court of New Jersey dismissed the writ upon the ground that the commission properly denied the application because of insufficiency of the utility's showing.

On page 8 of its brief, appellant states:

> "Little is said in the Kansas statute in regard to the nature of the proceedings before the Commission and the same had been established more by custom and the decision of the courts than by statutory procedure."

The following excerpts from public utility cases will show that the custom and general practice of the Commissions in all states has been to deny the application where the record is insufficient to justify a finding on all material issues.

In *In re Long Island R. R. Co.*, P. U. R. 1928-C, 705, it was said:

> "The burden of proving the proposed rates to be just and reasonable rests squarely upon the utility. *** The commission, as a fact finding body, cannot make an order based on conjecture and should be furnished with sufficient facts to show definitely the reasonableness of proposed rates."

In the opinion it was said:

> "The burden of proof to justify the reasonableness of the proposed tariffs was upon the railroad company. The manner, form and extent of its proof was of its own choosing. The failure to supply ad-

ditional or more persuasive cost figures was brought to its attention during the progress of the proceedings. *** It follows that an order should be made dismissing the filed schedules because of the failure of the company to furnish satisfactory or convincing proof that the proposed increased rates are just and reasonable." (Page 747.)

The general practice of commissions in all states has been to deny the application where the record is insufficient to justify an order.

"The application for increased rates should be denied when the record is such that from it no finding can be made that the proposed rates are just and reasonable." (*Bell Telephone Company*, P. U. R. 1925-E, 242.)

"An order with reference to a continuance of a public utility company's present rates will be denied when there is no evidence before the Commission to justify such an order." (*City Light & Transit Co. of Sedalia*, P. U. R. 1922-E, 474.)

"A natural gas distributing company applying for increased rates failed to carry the burden of proof placed upon it by statute when it failed to inform the commission as to the actual cost of gas purchased from the affiliated company." (*Point Pleasant Natl. Gas Co.*, P. U. R. 1927-B, page 805.)

In the above case the application was dismissed without prejudice.

It could not be very seriously contended that a public utility had exhausted its remedy before a fact-finding tribunal where there was not sufficient evidence before the fact-finding body to justify a finding.

Cases can be found from practically every commission in the Union, holding that the burden is upon the utility to prove every issue material in the determination of a rate case.

Listed below are some of the decisions rendered since 1921:

"Upon the hearing of an application of a public utility company to increase its rates or charges, the burden of showing that the proposed increase is just and reasonable is cast upon the utility." (*National Gas Co. v. Public Service Commission,* [W. Va.] 121 S. E. 716.)

"An application for increased rates must be denied when the applicant fails to sustain the burden of proof as to the necessity for such increase by showing the present fair value of the property in addition to evidence as to the expense of operation and revenue received."

"The prayer of the applicants for increased rates must be denied because of their failure to sustain the burden of proof as to the necessity for such increase." (*Re Metz Tel. Co.,* P. U. R. 1927-E, 624.)

"The burden justifying the reasonableness of rates against which a complaint has been filed before the effective date rests upon the utility." (*Burrough of Warren v. Warren Water Co.,* P. U. R. 1924-B, 400.).

"Application for increased rates must show not only that the increase is justified because the existing rates are too low, but also that the proposed rates are themselves reasonable." (*Re Puente City Water Company,* P. U. R. 1921-C, 451.)

"The burden of proof as to the necessity for increased rates rests upon the utility." (*Thompson's Express & S. Co.,* P. U. R. 1921-A, 211.)

"A gas utility must prove the reasonableness of a new rate schedule in a proceeding instituted by complaint against certain schedules." (*Department of Public Works v. Tacoma L. & Imp. Co.*, P. U. R. 1925-A, 165.)

"A preponderance of evidence is required in order to establish legally the proposed rate increase as just and reasonable where by statute the utility has the burden of proof that such is the case." (*Re Logan Gas Company*, P. U. R. 1929-A, 232.)

"The burden of proof sustaining the reasonableness of increased rates was held to be upon the utility." (*Burrough of M. Cabon v. Pottsville Water Co.*, P. U. R. 1928-B, page 614.)

"Upon appearing before the commission for authority to increase rates the officers of a public utility should state definitely their conclusions as to the company's needs, or as to the rate schedule which they regard as necessary for the future, since this is the company's responsibility and a commission should not have delegated to it duties which are obtrusively and manifestly the company's." (*Re Comstock Ind. Telephone Co.*, P. U. R. 1922-B.)

"A telephone company applying for increased rates assumes the burden of proof to justify the increase; and it becomes incumbent upon the company to establish, to the satisfaction of the commission, the value of the property of the company in the state which is used and usable for the service of the public." (*Re Cumberland Tel. and Tel. Co.*, P. U. R. 1921-D, 858.)

The principle that the party upon whom rests the burden of proof must establish its case before it can obtain relief is too well determined to justify discussion.

There are three principles to be established to support the decree dismissing the bill of complaint.

1. The utility must exhaust its remedy before the Commission before seeking injunctive relief.

2. A utility has not exhausted its remedy before the Commission until it has produced evidence upon which findings can be made upon all material issues affecting the rate.

3. The cost of services rendered and gas furnished by a holding or affiliated company is a material issue in a rate case in determining the reasonableness of holding and affiliated company charges.

If these contentions are sustained, the bill of complaint was properly dismissed. They will be discussed in the order in which they appear.

## I.

### The utility must exhaust its remedy before the Commission before seeking injunctive relief.

As to whether or not a public utility must exhaust its remedy before the Commission before applying for judicial or injunctive relief there can be very little dispute. The legislature may within the limit of constitutional restrictions place regulation upon public utilities. Regulation of public utilities by the Public Service Commission is purely legislative or administrative. The courts will not interfere with legislative regulation until it has been abused, and the abuse will not be anticipated.

The legislative power to regulate utility rates would be absolutely destroyed if utilities were permitted to first

seek the courts to compel the legislative body to submit to the will of the utility.

Statements from a few of the cases determining this question follow. None can be found to the contrary.

In *Chicago, Burlington & Quincy R. Co. v. Winnett*, 162 Fed. 242, the court held:

"A court of equity is without power to interfere by injunction to control in advance the exercise of the legislative power conferred on the state railway commission by the constitution and statutes of Nebraska to fix reasonable and just rates for the transportation of property between points within the state, by restraining such commission from considering or acting upon the question of establishing new rates on any given commodities, or from giving notice to a railroad company of any order which may be adopted establishing such rates." (Syl.)

"Before complainant can secure judicial relief on account of past divisions of intrastate joint rates, it must first apply to state railroad and warehouse commission, and have the preliminary question of what is a fair division of the rates involved first determined by that commission." (*Backus-Brooks Co. v. Northern Pacific Ry. Co.*, 21 F. [2d] 4, Syl. 17.)

"Injunction will not lie on behalf of water company which is bound by franchise to supply water at specified rates to enjoin the public service commission to continue in force rates permitted by it in excess of the franchise rates as being confiscatory where *** the water company has not exhausted its remedy before the commission, by applying for relief as it was authorized by the Commission to do." (*Henderson Water Co. v. Corporation Commission*, 269 U. S. 277, 70 L. Ed. 273.)

"Railroad companies may not be granted an injunction against the State Railroad Commission be-

The Supreme Court of the United States has held that the Public Service Commission of the state of Kansas cannot change rates without a finding as to reasonableness.

In *Wichita Railroad & L. Co. v. Public Utilities Commission*, 260 U. S. 47, 67 L. Ed. 124, the court in an opinion rendered by Chief Justice Taft held:

> "In the absence of any finding by the public service commission upon the question of reasonableness or unreasonableness of a rate which it is asked to change, its ruling authorizing the change cannot be supported by the presumption that there was evidence which would warrant a finding of unreasonableness, notwithstanding the statute provides that rates fixed by the Commission shall be *prima facie* reasonable. (For other cases see Evidence, 11, *a*, in Digest Sup. Ct. 1908.)" (Syl. 8.)

> "Under a statute permitting a public service commission to change contract rates of a public corporation if, after hearing, they are found to be unjust, an order changing a contract rate without such finding is void." (Syl. 9.)

The Western Distributing Company failed and refused to submit evidence upon material issues before the Commission upon which it could make findings. It must do so before it is in a position to seek injunctive relief.

In *Smith v. Illinois Bell Telephone Co.*, supra, the court said:

> "Specific findings with regard to the cost to the American Telegraph and Telephone Company of services rendered by it to a subsidiary company, in respect of which a charge is made to the subsidiary company, and the reasonable amount which should

> be allocated in this respect to the operating expenses of the intrastate business of the subsidiary company are necessary to a determination of the question whether rates prescribed by a state public utilities commission afford an adequate return."

In line with this decision it is imperative upon the Public Service Commission to make findings upon the cost to the holding and affiliated companies in respect to service charges figuring in the items of expense of the subsidiary company. Certainly the utility must produce sufficient evidence to enable the Commission to make all required findings.

The evidence which the Western Distributing Company refused to submit to the Public Service Commission must be submitted to the Federal Court to justify relief there. This same situation was before the Supreme Court of the United States in *Cincinnati, N. O. & T. P. R. Co. v. Interstate Commerce Commission*, 162 U. S. 184, 40 L. Ed. 935, and the court held:

> "It is not proper for railroad companies to withhold the larger part of their evidence from the Interstate Commerce Commission, and first adduce it in the circuit court in proceedings by the Commission to enforce its order; but the purposes of the act of congress to regulate commerce call for a full inquiry by the Commission in the first instance. (Syl. 4.)"

In a rate hearing before the Public Service Commission a definite rate must be established. The Commission cannot, when insufficient evidence is submitted, guess at what increase should be allowed. Although the record

might indicate the necessity for an increase, the Commission must have definite evidence upon which to base a definite rate.

The Western Distributing Company, in its application for an increase in rates, requested the installation of the "three-part rate". The "three-part rate" bases the payment to the pipe-line company on a percentage of the earnings of the distributing company and not on a fixed price at the city gate. Therefore the "three-part rate" can be constructed only after taking into consideration (*a*) the cost of operating and maintaining the producing and transmission system of the Cities Service Gas Company, and (*b*) the fair value of the producing and transmission system of that company. The record contains no evidence which would enable the Commission to give these matters consideration.

3.

**The cost of service rendered and gas furnished by a holding or affiliated company is a material issue to be determined in a rate case as a test of the reasonableness of the contracts.**

The necessity of the Commission taking into consideration cost of service rendered or gas supplied by an affiliated and holding company has been very definitely determined. If an affiliated or holding company is being unjustly enriched by charges made to a subsidiary company the excess charges must be deducted from the expense items. The subsidiary company is dominated and controlled by the holding company. To allow it to exact

from the subsidiary company an excessive charge for services rendered without taking such excessive charges into account in determining a proper rate would destroy any attempt at regulation.

The legislative power to regulate rates cannot be made subservient to the discretion of a holding company which may by exhorbitant and unreasonable charges, or in some other improper way, transfer the earnings of a subsidiary distributing company into what it is pleased to call "expense items" for its own enrichment. It matters little to the holding company whether the earnings appear as dividends from the subsidiary company or excess earnings on the part of the parent company. The money all goes into the same pocket.

It is true the Cities Service Gas Pipe Line Company which delivers gas to the Western Distributing Company is an Interstate pipe line. It is also true, however, that all the capital stock of the Cities Service Gas Company (the pipe line company), through intercorporate relations, is owned by the Cities Service Company, a holding Company. All of the capital stock of the Western Distributing Company, through intercorporate relation, is owned and controlled by the Cities Service Company, the same holding company, the earnings of both companies go directly to the treasury of the Cities Service Company.

The authority of the Public Service Commission to consider the reasonableness of contracts made between holding or affiliated companies is not a novel question. That principle was pronounced by the Courts in several

cases prior to the decision in Smith v. Illinois Bell Telephone Company, 282 U. S. 133.

In the case of the United Field Gas Company v. Railroad Commission, 278 U. S. 300, the court said:

> "We need not labor the point that a Public Service Corporation may not make a rate confiscatory through the device of a contract unduly favoring a subsidiary or a corporation owned by its own stockholders."

It was also held:

> "In computing the income of a natural gas company to determine whether or not a rate is confiscatory, it may be credited with 50 per cent of the net earnings of a subsidiary corporation which is accorded the privilege of extracting gasoline from the gas, if it bears the expense of property used for extraction in excess of the proportional return received by it for the extraction, and the profits of the subsidiary are excessive, although by contract it is entitled to only one-eighth of the gross profits from the extraction." (Syl. 16.)

This is true regardless of the fact that the supply company is transporting gas in interstate commerce. In the case above referred to, the United Field Gas Company was engaged in the business of producing natural gas from gas fields located principally in West Virginia which it sold to consumers in West Virginia, Kentucky and Ohio. This rule was also recognized in the cases of Houston v. Southwestern Bell Telephone Company, 259 U. S. 318 and Southwestern Bell Telephone Company v. The Public Service Commission, 262 U. S. 276.

In opposition to this theory, the appellant on page 32 of its brief quotes in the first paragraph of the syllabus, in the case of Missouri v. Kansas Natural Gas Company, 265 U. S. 298, as follows: "The business of piping natural gas from one state to another and selling it, not to consumers, but to independent distributing companies which sell it locally to the consumers, is interstate commerce free from interference."

It will be noticed in this statement that the court carefully mentioned the fact that the pipe line company was selling gas to independent distributing companies. The pipe line company in that case was not selling to affiliated or subsidiary companies.

At the present time, there is no Federal legislation regulating pipe line companies selling gas in interstate commerce. If the states are without authority to investigate the reasonableness of contracts made between interstate pipe line companies and subsidiary or affiliated distributing companies, there is no way in which the states can regulate the rate at which gas is to be sold to the local consumer.

Because of the expenditure involved in the construction of a gas pipe line system, it is not practicable for two pipe line companies to invade the same territory. Where a pipe line company is supplying a territory such as that now under consideration it has virtually a monopoly so far as sales to distributing companies are concerned. It is not possible for the distributing plants to buy gas from some other source, or at a cheaper rate, because another pipe line company cannot economically

invade the territory. Where both the pipe line and the distributing plants are owned and controlled by a common holding company, a situation is created which makes it possible for the pipe line company, through its holding company, to exact most any price it desires from the affiliated distributing company for gas purchased. This cost is passed on to the local consumer in the form of excessive rates made possible by heavy expense items for gas purchased.

It is an old established rule of law that the states may make regulations indirectly affecting interstate commerce when needed to protect or regulate matters of local interest until congress regulates the subject matter for itself.

This rule was applied in the case of Pennsylvania Gas Co. v. Public Service Commission, 252 U. S. 23, to an interstate gas pipe line. Although this case was disapproved in East Ohio Gas Co. v. Tax Commission, 75 L. ed. 700, it was only to the extent that the sale of gas at the burner tips was intrastate and not interstate commerce and the rule as above stated was in no way disapproved or effected. In the Pennsylvania Gas Co. case, the court said:

> "The general principle is well established and often asserted in the decisions of this court that the state may not directly regulate or burden interstate commerce. That subject, so far as legislative regulation is concerned, has been committed by the Constitution to the control of the Federal Congress. But while admitting this general principle, it, like others of a general nature, is subject to qualifications not inconsistent with the general rule which now are as well established as the principle itself.

> In dealing with interstate commerce it is not, in some instances, regarded as an infringement upon the authority delegated to Congress, to permit the states to pass laws indirectly affecting such commerce, when needed to protect or regulate matters of local interest. Such laws are operative until Congress acts under its superior authority by regulating the subject-matter for itself."

Again, in the opinion, the Court stated further:

> "It may be conceded that the local rates may effect the interstate business of the company. But this fact does not prevent the state from making local regulations of a reasonable character. Such regulations are always subject to the exercise of authority by Congress, enabling it to exert its superior power under the commerce clause of the Constitution."

We respectfully submit that if the interstate commerce feature of the gas pipe line business is indirectly affected by the commission's investigation of the reasonableness of the contract by the affiliated distributing company, it is only to the extent needed to protect and regulate matters of local interest to the state pertaining to the rates to be charged to the local consumers by the distributing company.

We are also reminded of the fact that because of the close relationship between the pipe line company and the distributing company, both being owned and controlled by a common holding company, that for all practical purposes, both the pipe line and the distributing plant are under the control and supervision of one company, and do not operate independently of each other so far as management is concerned.

In the present case, it will be noted that the lower court carefully restricted the investigation which the commission could make into the pipe line rate to a test as to whether or not the contract between the pipe line company and the distributing company was reasonable. In the opinion of the lower court (R. 52) it was stated:

> "It cannot be questioned that the forty-cent rate at the city gate is an interstate rate which the commission cannot directly regulate. It does not follow, however, that the commission may not inquire into the reasonableness of that rate for the purpose of fixing the local rates which plaintiff may charge in the city of El Dorado. Smith v. Illinois Bell Tel. Co., 282 U. S. 133; Houston v. Southwestern Bell Tel. Co., 259 U. S. 318; Southwestern Bell Tel. Co. v. Pub. Serv. Comm., 262 U. S. 276. It is my opinion that the commission, in making inquiry into the city gate rate, should not approach that question as it would were it empowered to fix such rate. The inquiry should be for the purpose of determining whether the contract between plaintiff and the Cities Service Gas Company, an affiliated corporation, is fair and reasonable, and such as prudent business men acting in good faith and in the exercise of a sound discretion would have entered into under similar circumstances. To put it another way: The commission may not fix an interstate rate, but it may determine whether a corporation buying gas from a related and affiliated corporation is paying such affiliated corporation an unfair and fictitious charge, under the existing circumstances, for gas at the city gate, and using that charge as one of the elements of cost upon which it seeks to have the local rate fixed. The commission may make inquiry into value of property, costs, profits, limitation on source of supply, and other pertinent factors in determining whether, under the existing circumstances, the con-

> tract is fair and reasonable and was made in good faith; but it may not go to the extent of fixing and determining the rate at the city gate."

The lower court carefully restricted its decision and opinion to conform to the previous rule announced in the cases therein cited. It is our belief that the opinion therein announced sustained the decree of dismissal. We do not believe, however, that the opinion goes far enough. So far as the facts are concerned in this case, the Intercompany relations are identically the same as that in the case of Smith v. Illinois Bell Telephone Company, 282 U. S. 133, and in that case, the rule was properly extended to make the cost of service rendered by a holding or affiliated company and the rate of return earned by it the full measure of the test of the reasonableness of the contract.

In the Smith case, the court in speaking of the necessity of findings as to the profits made by an affiliated manufacturing company on the sale of equipment to the telephone company and as to the extent to which such profits figures in estimates upon which is predicated the claim that the telephone rates fixed by the Public Utilities Commission were confiscatory, said:

> "Contentions of the appellants in this relation are directed to the purchases from the Western Electric Company and to the payments to the American Company under what is called its 'license contract'. It appears that the Illinois Company has purchased practically all its equipment from the Western Electric Company. The state commission in laying the basis for its rate order made no finding as to the

fairness of the prices on such purchases. On the record in this suit, the court concluded that the city had failed to support its contention that these prices were exhorbitant. The court said that it appeared that for the past fourteen years the average profit of the Western Electric Company on its total business had not been 'in excess of 7 per cent and never above 10 per cent'. That fact has evidentiary value but the finding does not go far enough. The Western Electric Company not only manufactured apparatus for the licensees of the Bell System, but engaged in other large operations, and it cannot be merely assumed or conjectured that the net earnings on the entire business represent the net earnings from the sales to the Bell licensees generally or from those to the Illinois Company. Nor is the argument of the appellants answered by a mere comparison of the prices charged by the Western Electric Company to the Illinois Company with the higher prices charged by other manufacturers for comparable material, or by the Western Electric Company to independent telephone companies. The point of the appellants' contention is that the Western Electric Company, through the organization and control of the American Company, occupied a special position with particular advantages in relation to the manufacture and sale of equipment to the licensees of the Bell system, including the Illinois Company, that is, that it was virtually the manufacturing department for that system, and the question is as to the net earnings of the Western Electric Company realized in that department, and the extent to which, if at all, such profit figures in the estimates upon which the charge of confiscation is predicated. We think that there should be findings upon this point (p. 152)."

Again, in the opinion, the Court said:

> "In view of the findings, both of the state commissions and of the court, we see no reason to doubt that valuable services were rendered by the American Company, but there should be specific findings by the statutory court with regard to the cost of these services to the American Company and the reasonable amount which should be allocated in this respect to the operating expenses of the intrastate business of the Illinois Company in the years covered by the decree (P. 157)."

Under the authority of this decision, it is our contention that there should be specific findings in regard to the cost of the services of the holding and affiliated companies in order to determine the reasonable amount which should be allocated in this respect to the operating expenses of the Western Distributing Company.

On page 26 of its brief, appellant states:

> "A reading of the motion upon which the proceedings before the Commission were dismissed shows very clearly that at that time the commission construed the Smith case as requiring a showing in every rate case as to the cost of gas to supply the company at the gate of each City where the distributing company and supply company are affiliated."

It is further contended that the cost of supplying gas to each distributing company is the same all over the system and the cost cannot be separated. This contention was not made before the Commission. At the hearing before the court below, affidavits were introduced by the appellant to that effect. We cannot see where the obligation of the appellant is changed by that showing.

If the situation is as claimed by the appellant, it was its duty to make such proof before the Commission and then proceed to justify the reasonableness of the system rate. The reasonableness of that contracted rate once established, would, if the appellant's theory in opposition to zoning were correct, eliminate the necessity of such showing in but one rate case. When the hearing was had before the lower court, the appellees made a stipulation as shown on page 47 of the record, as follows:

> "At the hearing, it was stipulated and agreed by the Commission through its counsel for the purposes of this hearing only, that the territory served by the pipe line company could not be segregated into separate zones for the purpose of fixing different cost of gas at the city gates in different zones."

This would simplify the controversy by enabling the company to make one showing as to the reasonableness of the pipe line rate over the entire system and the obligation upon the appellant to show the reasonableness of the contract for gas at the city gate exists whether it be for each individual distribution company or for the city as a whole.

To the two other items in controversy, the same reason would apply as that advanced in the previous argument.

> "The Gas Service Company operates and manages the Western Distributing Company and keeps the books of the Western Distributing Company in Kansas City, Missouri, and charges to the Western Distributing Company certain sums annually purporting to be the Western Distributing Company's share of expense of the Gas Service Company. These charges,

amounting to $5,970.11, were included in the items of expense for the El Dorado plant, also unclassified expense amounting to $4,667.91, which was reimbursement for specific services rendered. (R. 63)"

In view of the fact that the Gas Service Company owns all of the capital stock of the Western Distributing Company, there should be a showing made to the Commission as to what it cost the Gas Service Company to operate and manage the Western Distributing Company.

"Henry L. Doherty, doing business as Henry L. Doherty & Company, through agency contracts, manages and controls the operations of all these companies, both in their relations with the public and between themselves.

"The Western Distributing Company pays 1 3/4 per cent of its gross revenue to Henry L. Doherty & Company. This payment in the amount of $3,454.43 was included in the items of expense for the El Dorado plant." (R. 63)

In view of the fact that Henry L. Dougherty and Company for all practical purposes has control of the voting stock of the Cities Service Company, which, through intercorporate relation owns and controls the stock of the Western Distributing Company, there should be a showing made as to what it costs Henry L. Doherty and Company for services performed, if any, and to show whether or not Henry L. Doherty and Company renders any services to Western Distributing Company, or whether its efforts are expended in the management of the Cities Service Company in the sale of its securities and that service paid for by the local operating units.

## ASSIGNMENT OF ERROR No. IV.

On page 25 of its brief, appellant objects to the failure of the lower court to make its requested finding set out as 7A on page 45 of the record. It does appear that an inadvertent admission was erroneously made in paragraph 13 of appellees' answer, as follows:

> "It is admitted that the defendant, the Public Service Commission, should and did take notice of the decisions referred to and the respective records, but it is averred that the defendant, The City of El Dorado, had and has no knowledge thereof." (R. 38)

There can be no question but what the Commission must take notice of the decision of both the State and Federal Courts. The record in these cases, however, was not before the Commission. After the hearing was dismissed by the Commission, counsel for appellant moved to reopen the case and introduce the record of the Wichita Gas case, but after attorneys for the Commission asked for time to examine the record, counsel for appellant stated: "I will withdraw the motion. I would rather get it started in the courts and find out what the law is now." (R. 80) There was, therefore, nothing before the Commission upon which it could make a finding, and the counsel intentionally withdrew such record from the Commission for the purpose of having determined the question of whether or not the reasonableness of the contracts between the distributing company and the holding or an affiliated company was a matter into which the Commission could inquire.

This fact being in the undisputed evidence presented to the lower court, we contend that the requested finding was probably rejected, especially in view of the fact that in the hearing before the Commission the limited investigation of reasonableness of the contracts in the Wichita gas case was disclosed.

> "In response to an inquiry by Mr. Montgomery, then a member of the Commission, it was stated: That the only valuation introduced was a general estimate by Mr. Hamilton, chief engineer of Henry L. Doherty & Company, which was a general estimate in round figures. No exhibit was introduced, but his testimony occupied a day or two. It was stated by counsel for the applicant that no valuation, to his knowledge, had been made of the pipe line system; that he had been informed that it would cost $50,000.00 to $100,000.00 to make it." (R. 68)

## CONCLUSION.

We respectfully submit that whether or not the present rate for the Western Distributing Company's operating unit at El Dorado, Kansas, is confiscatory, cannot be determined until there is a showing made as to what it costs the affiliated and holding companies to render the services and furnish gas and a showing made as to the profit of such company and the extent to which such profit figures in estimates on which is predicated the claim that the present rate at El Dorado, Kansas, is confiscatory; that the appellant is required to make such showing before the Commission, and that the appellant failed and refused to make such showing or to give the

Commission access to its books, so that it could acquire the information for itself.

We further submit that the appellant has not exhausted its administrative remedy before the Commission, and that the court below ruled correctly in denying appellant's application for a preliminary injunction and in dismissing the bill of complaint.

CHARLES W. STEIGER,
Topeka, Kansas,
EARL H. HATCHER,
Topeka, Kansas,
Solicitors for Appellees.